No. 06-484

In the Supreme Court of the United States

TELLABS, INCORPORATED AND RICHARD C. NOTEBAERT,
Petitioners,

v.

MAKOR ISSUES & RIGHTS, LTD., *et al.*,
Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

BRIEF FOR THE SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION AND THE CHAMBER OF COMMERCE OF THE UNITED STATES OF AMERICA AS *AMICI CURIAE* IN SUPPORT OF PETITIONERS

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INTEREST OF THE *AMICI CURIAE*

The Securities Industry and Financial Markets Association (SIFMA) is a trade association that results from the November 1, 2006 merger of the Securities Industry Association and The Bond Market Association. It brings together the shared interests of more than 650 securities firms, banks and asset managers. SIFMA's mission is to promote policies and practices that expand and improve markets, foster the development of new products and services and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests in the United States and globally. It has offices in New York, Washington, D.C., and London.

The Chamber of Commerce of the United States of America ("Chamber") is the world's largest business federation. The Chamber's underlying membership includes more than three million companies and professional organizations of every size, in every industry sector, and from every region of the country. An important function of the Chamber is to represent the interests of its members in matters before Congress, the Executive Branch, and the courts. To that end, the Chamber regularly files *amicus curiae* briefs in cases that raise issues of vital concern to the nation's business community.[1]

The question presented here—the proper test for determining the sufficiency of scienter allegations in securities fraud cases—is an issue of recurring importance to the financial industry and to investors. *Amici* have a vital interest in ensuring that the uniform standards of the Private Securities Litigation Reform Act ("PSLRA"), which Congress passed

[1] Pursuant to Rule 37.6, *amici* affirm that no counsel for a party authored this brief in whole or in part and that no person other than *amici* and their counsel made a monetary contribution to its preparation or submission. The parties' letters consenting to the filing of this brief have been filed with the Clerk's office.

to curb vexatious litigation, are not defeated by the inability of federal courts of appeals to agree on how those standards should be applied. *Amici* believe that the experience of their members will assist the Court in assessing the harm that results from the Seventh Circuit's lax approach to scienter.

SUMMARY OF ARGUMENT

To avoid dismissal, the PSLRA requires that securities fraud plaintiffs plead "with particularity" facts giving rise to a "strong inference" of scienter. 15 U.S.C. § 78u-4(b)(2). Because the courts of appeals are hopelessly divided over the meaning of this frequently litigated standard, see Part I, *infra*, deficient complaints like the one in this case often escape dismissal. That result frustrates the PSLRA's goal of curbing abusive securities litigation, which has harmful consequences for the national economy. See Part II, *infra*. This Court's review is needed now.

The Seventh Circuit held that plaintiffs' complaint met the strong inference of scienter requirement because a reasonable person "could infer" scienter from the pleaded facts. Pet. App. 20a. The Court should reject that overly permissive test. As explained below, the Seventh Circuit's scienter test moves in the opposite direction from that chosen by Congress, significantly easing plaintiffs' burden and thereby encouraging the abusive strike suits that the PSLRA set out to prevent with heightened pleading requirements. The lax "could infer" test will also harm defendants and the markets without providing significant enforcement benefits. Given the many remedies available for alleged fraud, there is no reason for this Court to permit private suits based on conclusory allegations of scienter. When one disregards such assertions and focuses solely on the facts actually alleged, this complaint does not pass muster even under ordinary pleading standards, much less the PSLRA's heightened standard. See Part III, *infra*.

ARGUMENT

I. THE OUTCOME OF THIS CASE TURNS ON A CIRCUIT SPLIT THAT THIS COURT SHOULD RESOLVE.

The circuits disagree about the role that competing inferences should play in deciding whether a plaintiff has alleged facts that give rise to a "strong inference" of scienter. Here, the Seventh Circuit rejected the approach of four other circuits, which consider only the "most plausible" of competing inferences. Pet. App. 20a (quoting *Helwig* v. *Vencor, Inc.*, 251 F.3d 540, 553 (6th Cir. 2001) (en banc)); see Pet. 19. It favorably cited the Tenth Circuit's "facts that would convince a reasonable person" test, Pet. App. 21a (quoting *Adams* v. *Kinder-Morgan, Inc.*, 340 F.3d 1083, 1105 (10th Cir. 2003)), as well as the Second, Third, and Eighth Circuits' view that a strong inference arises when a defendant "had access to information" suggesting that his or her public statements were inaccurate. Pet. App. 23a (quoting *Florida State Bd. of Admin.* v. *Green Tree Fin. Corp.*, 270 F.3d 645, 665 (8th Cir. 2001)); see Pet. 20-21, 24. But the Seventh Circuit ultimately adopted a still more lax test, asking only whether a reasonable person "could infer" scienter from the pleaded facts. Pet. App. 20a.

This conflict cannot be dismissed as a quibble over differences in the language used to explain the strong inference of scienter standard. That standard is one of the most frequently litigated provisions of the PSLRA. Pet. 17. The lower courts' inability to agree on its meaning has damaged the effectiveness of the statute in a way that this Court should repair. Confusion about how the circuits' different tests apply in practice allows deficient complaints to escape dismissal—as occurred here, see Part III, *infra*—frustrating Congress's goal of a heightened and uniform pleading standard.

This Court should grant certiorari to resolve the conflict among the circuits and announce clear rules that can be applied consistently from case to case. As the independent, bi-

partisan Committee on Capital Markets Regulation recently concluded, "there needs to be greater clarity to private litigation under Rule 10b-5" regarding the definition of scienter because "[n]eedless uncertainty will drive participants to competitor market centers." Interim Report of the Committee on Capital Markets Regulation vii, xii, 80-81 (Nov. 30, 2006), available at http://tinyurl.com/u4qaz ("Interim Report"). *Amici* submit that the correct scienter standard requires dismissal unless the facts alleged strongly tend to exclude innocent explanations for the challenged conduct. But under *any* reasonable reading of the strong inference standard the facts pleaded here do not pass muster. See Part III, *infra*. The Seventh Circuit's "could infer" test is far too lax and should be rejected.

II. THE UNAMBIGUOUS CONGRESSIONAL INTENT UNDERLYING THE PSLRA REQUIRES A STRONGER SCIENTER STANDARD.

The Seventh Circuit held that plaintiffs need only plead facts from which a reasonable person "could infer" scienter. Pet. App. 20a. But the PSLRA was meant to create a "uniform and more stringent" scienter pleading requirement, H.R. Conf. Rep. No. 104-369, at 41 (1995), reprinted in 1995 U.S.C.C.A.N. 730 ("H.R. Conf. Rep."), which bars such speculative claims. Accordingly, this Court should reject the Seventh Circuit's test and insist on a more rigorous standard that screens out conjectural claims of scienter.

A. The Historical Background Of The PSLRA Demonstrates The Importance Of A Stronger Standard.

In determining Congress's goal in enacting the PSLRA, it is necessary to begin with the problems that prompted enactment of legislation reforming securities litigation. "[A]s a matter of policy," this Court has long rejected "expansive imposition of civil liability" for securities fraud under Section 10(b) because that implied cause of action "presents a danger of vexatiousness different in degree and in kind from

that which accompanies litigation in general." *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 739-740 (1975); see *Merrill Lynch, Pierce, Fenner & Smith, Inc.* v. *Dabit*, 126 S. Ct. 1503, 1510 (2006). In particular, this Court has recognized that, because of the risk of a jury verdict holding defendant liable for huge market losses, "even a complaint which by objective standards may have very little chance of success at trial has a settlement value to the plaintiff out of any proportion to its prospect of success" if the plaintiff is able to "prevent the suit from being resolved against him by dismissal or summary judgment." And the threat of costly and disruptive discovery adds a further "*in terrorem* increment" to the settlement value of a suit. *Blue Chip Stamps*, 421 U.S. at 740-741.

Accordingly, this Court has repeatedly limited the scope of private securities damages actions to curtail their coercive potential and make meritless claims easier "'to dispose of before trial.'" *Blue Chip Stamps*, 421 U.S. at 742-743; see *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976) (requiring proof of scienter, not mere negligence); *TSC Indus.* v. *Northway, Inc.*, 426 U.S. 438 (1976) (rejecting lax definition of materiality); *Santa Fe Indus.* v. *Green*, 430 U.S. 462 (1977) (limiting Section 10(b) to manipulative or deceptive conduct); *Schreiber* v. *Burlington Northern, Inc.*, 472 U.S. 1 (1985) (confining Section 14(e) to manipulative acts that involve misrepresentation or nondisclosure); *Central Bank of Denver* v. *First Interstate Bank*, 511 U.S. 164, 189 (1994) (rejecting aiding and abetting claims under Section 10(b) because they would engender "uncertainty and excessive litigation").

Despite these and other judicially imposed limitations, "nuisance filings, targeting of deep-pocket defendants, vexatious discovery requests, and 'manipulation by class action lawyers of the clients whom they purportedly represent' * * * resulted in extortionate settlements, chilled any discussion of issuers' future prospects, and deterred qualified individuals from serving on boards of directors." *Dabit*, 126 S. Ct. at

1510-1511 (quoting H.R. Conf. Rep. at 31). Congress responded to this "significant evidence of abuse," which undermined "American capital markets" and caused "serious injuries to innocent parties" who were "forced to pay exorbitant 'settlements.'" H.R. Conf. Rep. at 31-32. Congress passed the PSLRA in 1995 "to protect investors, issuers, and all who are associated with our capital markets from abusive securities litigation." *Ibid.*

A key part of Congress's "effort to curb these perceived abuses" was heightened pleading requirements for Section 10(b) claims, including the strong inference of scienter standard. *Dabit*, 126 S. Ct. at 1511. The flood of Section 10(b) class actions filed since the stock market bubble burst in 2000 confirms that the need for a protective scienter pleading standard remains acute. See Pet. 17. The Committee on Capital Markets Regulation recently observed that such class action lawsuits have "been accompanied by a rise in settlement sizes to new and unprecedented levels." Interim Report at 75 (capitalization altered).

Nevertheless, the Seventh Circuit has adopted an approach to scienter that moves headlong in the opposite direction, significantly easing plaintiffs' burden and thereby encouraging abusive strike suits. Given the availability of nationwide service of process, see 15 U.S.C. §§ 77v & 78aa, most future suits are likely to be brought in the Seventh Circuit, where plaintiffs now have a better prospect of avoiding dismissal and thus obtaining larger settlements. Because allowing the Seventh Circuit's approach to persist "would bring about harm of the very sort the [PSLRA] seek[s] to avoid," the Court should take this opportunity to review and reject it. *Dura Pharms., Inc.* v. *Broudo*, 544 U.S. 336, 347 (2005).

B. The Seventh Circuit's Lax "Could Infer" Test Would Do More Harm Than Good.

The Seventh Circuit's permissive scienter pleading rule "will ultimately result in more harm than good." *Hochfelder*,

425 U.S. at 214 n.33 (quoting *Blue Chip Stamps*, 421 U.S. at 747-748). That rule substantially harms defendants and the markets generally while providing few countervailing enforcement benefits.

1. By relaxing the PSLRA's strict pleading standards, the Seventh Circuit's decision will increase the pressure on defendants to settle even insubstantial claims and thus encourage plaintiffs to file them. Empirical studies have shown that "[f]or practical purposes, the merits do not matter" in Section 10(b) class actions that proceed beyond the dismissal stage. Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497, 501 (1991) (Section 10(b) became "a grotesquely inefficient form of insurance against large stock market losses" that "encourages the filing of more and weaker suits"). Bet-the-company damages claims and huge litigation costs force defendants to pay enormous settlements that are neither "voluntary," because the risks mean that trial is not "a practically available alternative," nor "accurate," because "the strength of the case on the merits has little or nothing to do with determining the amount of the settlement." *Id.* at 499; accord Romano, *The Shareholder Suit: Litigation without Foundation?*, 7 J. L. ECON. & ORG. 55 (1991).

The costs of abusive litigation are "'an Achilles heel for our economy.'" Deborah Solomon, *Treasury's Paulson Warns of the Costs of Rules Overlap*, WALL ST. J., Nov. 21, 2006, at A2 (quoting Secretary of Treasury). These costs are borne disproportionately by the most innovative and entrepreneurial companies, which are targeted because the volatility in their share price attracts the attention of the plaintiffs' bar.[2] And abusive securities class action litigation has enor-

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[2] See *Securities Litigation Reform Proposals: Hearings on S. 240, S. 667, and H.R. 1058 Before the Subcomm. on Securities of the S. Comm. on Banking, Housing, and Urban Affairs*, 104th Cong., 1st Sess. 109 (1995) (testimony of George Sollman on behalf of the American Electronics Association) (estimating that about half of

mously destructive ripple effects. The risk of open-ended liability deters competent individuals from serving as independent directors on corporate boards. S. Rep. No. 104-98, at 21 (1995), reprinted in 1995 U.S.C.C.A.N. 679. That risk also extends to investment bankers and other professionals essential to capital raising and efficient market operation, driving up the cost of their services. Accounting firms, often named as deep-pocket defendants, become less willing to perform auditing services. *Id.* at 21-22. "[N]ewer and smaller companies," in particular, are often unable to obtain high-quality professional services, because their "business failure would generate securities litigation against the professional, among others." *Central Bank*, 511 U.S. at 189; H.R. Rep. No. 104-50, at 20 (1995) ("Fear of litigation keeps companies out of the capital markets," and "businesses suffer as auditors and directors decline engagements and board positions"); Alexander, *supra*, 43 STAN. L. REV. at 570-573. D&O insurers must increase premiums or stop underwriting policies altogether. S. Rep. No. 104-98, at 21. And foreign companies are deterred from listing their securities on domestic stock exchanges.[3]

Lax scienter pleading rules also disserve the core goal of the securities laws: ensuring the free flow of information critical to investors and to market efficiency. H.R. Conf. Rep. at 42 ("Abusive litigation severely affects the willingness of

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the top 100 companies in Silicon Valley have been subjected to a securities class action lawsuit at least once).

[3] See Paul Atkins, *A Serious Threat to Our Capital Markets*, WALL ST. J., June 10, 2006, at A12 (SEC Commissioner Atkins explains that "[l]itigation risks * * * lessen the international appetite for our capital markets"); *Common Sense Legal Reform Act: Hearings on H.R. 10 Before the Subcomm. on Telecommunications and Finance of the H. Comm. on Commerce*, 104th Cong., 1st Sess. 221, 224 (1995) (statement of former SEC Chairman Richard C. Breeden) ("Based on conversations with potential issuers of securities all over the world, the fear of litigation inhibits foreign firms from participating in the U.S. market[s]").

corporate managers to disclose information to the marketplace"). A firm that discloses information "inevitably takes the risk of excessive optimism and excessive pessimism." EASTERBROOK & FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 339 (1991). A "rule penalizing excesses in either direction would lead to silence" about a company's prospects, paradoxically creating an environment of secrecy in which dishonest practices can thrive. *Ibid.*; Pet. App. 8a.

Investors particularly "want the issuer's own view of its future." KRIPKE, THE SEC AND CORPORATE DISCLOSURE 25 (1979). Broad scienter theories bring the threat of massive liabilities for such prognostications, however, creating a potent disincentive to discuss the company's future. See Backman, *Forward-Looking Statements and Cautionary Language After the 1995 Reform Act*, in PLI, SAILING IN "SAFE HARBORS" 153, 158-159, 208-209 (1997). Corporate managers' communications with analysts, which are "necessary to the preservation of a healthy market," are also muzzled by the risk of Section 10(b) suits based on conclusory scienter allegations. *Dirks* v. *SEC*, 463 U.S. 646, 658-659 (1983); see SEC, Release No. 33-7881, 65 Fed. Reg. 51716, 51718 n.19 (2000) ("fear of legal liability" "chill[s]" communications with analysts). When SEC disclosure requirements do not make silence an option, issuers may respond to the threat of unconstrained liability with defensive disclosure that "bur[ies] the shareholders in an avalanche of trivial information." *TSC*, 426 U.S. at 448; see *Basic Inc.* v. *Levinson*, 485 U.S. 224, 231 (1988).

Allowing Section 10(b) suits to proceed on the basis of speculative scienter theories thus detracts from the quantity and quality of information received by investors. In adopting more stringent limits on private damages actions in the PSLRA, Congress meant to address the concern that Section 10(b) suits had "'chill[ed]' the 'robustness and candor of disclosure.'" H.R. Conf. Rep. at 43; see H.R. Rep. No. 104-50, at 19 ("abuse of the 10b-5 system * * * deters the voluntary disclosure of information that the Federal securities laws

were designed to promote"); S. Rep. No. 104-98, at 5. This Court has refused to interpret the Exchange Act in ways that undermine the free flow of information, and it should do so once again here. *Dirks*, 463 U.S. at 658-659.

2. As the Committee on Capital Markets Regulation has explained:

> The modern securities class action lawsuit creates a heavy burden for public companies; without a substantial social benefit, this burden cannot be justified. * * * [H]owever, the public value of the securities class action litigation is questionable.

Interim Report at 78.

Speculative claims of fraud are of little benefit to shareholders—even to shareholder plaintiffs. Every delayed announcement of accurate firm information produces both winners (who sold during the period of inflation) and losers (who bought then and sold after disclosure of the truth). POSNER, ECONOMIC ANALYSIS OF THE LAW 489 (5th ed. 1998). "Over the long run, any reasonably diversified investor will be a buyer half the time and a seller half the time" and will not benefit from "a legal rule that forces his winning self to compensate his losing self over and over." EASTERBROOK & FISCHEL, *supra*, at 340; see Interim Report at 79; Thakor, *et al.*, *The Economic Reality of Securities Class Action Litigation* 1 (U.S. Chamber Institute for Legal Reform 2005), available at http://tinyurl.com/ua8uq (explaining that diversified institutional investors in particular are for this reason overcompensated as a result of litigation).

Such wealth transfers also entail significant transaction costs. To the extent that class members still own shares in the issuer, "payments by the corporation to settle a class action amount to transferring money from one pocket to the other, with about half of it dropping on the floor for lawyers to pick up." Alexander, *Rethinking Damages in Securities Class Actions*, 48 STAN. L. REV. 1487, 1503 (1996); see Interim Report at 79 (discussing the fees of plaintiffs' attorneys, defense

costs, and the high cost of insurance). Given that "the average securities class action settles for between two percent and three percent of the investors' economic losses," "it is not clear that there is any positive recovery in the average securities class action" after accounting for these transaction costs. Interim Report at 79.

This Court need have no fear that requiring Section 10(b) plaintiffs to satisfy a rigorous, non-speculative scienter standard, as Congress intended, will undermine the deterrence and compensation policies of the securities laws or hobble their enforcement. Meritorious private securities fraud suits, of course, will meet the scienter standard. The "potential deterrent function" of allowing more suits is questionable "because virtually all the costs fall on the corporation and its insurer, which means they are ultimately borne by the shareholders." Interim Report at 78. Instead, other administrative and judicial remedies can be used to vindicate the relevant policies without causing the harms and transaction costs identified above.

For example, SEC regulations impose stringent reporting obligations on corporations, subject to SEC enforcement proceedings. Corporations must file quarterly and annual financial statements, which executives now must certify under threat of criminal penalty and disgorgement of their compensation and stock trading profits. 15 U.S.C. §§ 7241, 7243; 18 U.S.C. § 1349. Issuers also must file Form 8-K reports on any of a host of material corporate events, including agreements, acquisitions, disposition of assets, off-balance sheet financial obligations, and changes in officers or directors. SEC, Release No. 33-8400, 69 Fed. Reg. 15594 (2004).

The powers of the SEC to enforce these corporate disclosure obligations are substantial. The Commission may obtain injunctive relief, cease-and-desist orders, orders barring or suspending individuals from serving as an officer or director of an issuer of securities, and large civil penalties, including disgorgement of any gain. 15 U.S.C. §§ 78u, 78u-3. Un-

der the Sarbanes-Oxley Act, the SEC may earmark penalties and amounts disgorged "for the benefit of the victims" of the violation. 15 U.S.C. § 7246(a).

A person who willfully and knowingly makes a false or misleading statement of material fact may also be criminally liable and is subject to imprisonment for 20 years and multi-million dollar fines. 15 U.S.C. § 78ff. The Securities Act authorizes many similar remedies for misstatements made in connection with the registration of securities, for which liability may be established without proof of scienter. *Id.* §§ 77t, 77y.

During fiscal year 2006 alone, the SEC initiated 914 investigations of possible violations of the securities laws and brought 218 suits and 356 administrative proceedings against issuers and financial service providers. The Commission obtained orders requiring the payment of more than $3.3 billion in disgorgement and penalties from securities law violators.[4] In addition, the Department of Justice's Corporate Fraud Task Force has charged over 1,300 defendants and obtained over 1,000 guilty pleas and convictions since it was formed in July 2002.[5]

State officials may bring their own overlapping enforcement actions. Financial services industry self-regulatory organizations ("SROs"), such as the National Association of Securities Dealers and the New York Stock Exchange, also enforce regulations that implement and supplement the securities laws.[6] Together, all these checks curb unlawful prac-

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[4] SEC, 2006 PERFORMANCE AND ACCOUNTABILITY REPORT at 8, available at http://tinyurl.com/ygyfv8.

[5] See Department of Justice, Fact Sheet: Corporate Fraud Task Force (Aug. 9, 2006), available at http://tinyurl.com/yhj2v2.

[6] *E.g.*, NASD Notice to Members 99-86, *Imposition and Collection of Monetary Sanctions* (Oct. 1999), available at http://tinyurl.com/y3slbo (discussing fines, restitution, and disgorgement); see also NYSE Information Memo 05-77, *Factors*

tices and compensate injuries. Given the availability of these remedies, there is no reason for this Court to permit the conclusory allegations and speculative theories of scienter endorsed by the Seventh Circuit.

III. ORDINARY PLEADING RULES AND CASES ON COMPETING INFERENCES SET A SCIENTER PLEADING THRESHOLD HIGHER THAN THE SEVENTH CIRCUIT'S.

This Court should also reject the Seventh Circuit's "could infer" test because it allows complaints that do not satisfy even ordinary rules of notice pleading to escape dismissal. Under any reasonable reading of the strong inference standard the facts pleaded here do not pass muster.

1. This Court's decisions establish two fundamental rules of pleading that bear decisively on this case. First, a complaint must allege facts, not merely conclusions, that show the plaintiff is entitled to relief under the governing substantive law. Second, it is the facts alleged, not unalleged facts that the plaintiff might later prove, that must support the claim for relief.

When a defendant tests the legal sufficiency of a pleading by filing a motion under Rule 12(b)(6), courts accept the *facts* alleged in the complaint as true for purposes of evaluating whether the complaint "state[s] a claim upon which relief can be granted." Fed. R. Civ. P. 12(b)(6); see *Leatherman* v. *Tarrant County Narcotics Intelligence & Coordination Unit*, 507 U.S. 163, 164 (1993). By contrast, courts need not accept the truth of allegations that are merely conclusions, characterizations, or inferences.[7]

Considered by the NYSE Division of Enforcement in Determining Sanctions (Oct. 7, 2005), available at http://tinyurl.com/y3ro8p.

[7] See, *e.g.*, *Papasan* v. *Allain*, 478 U.S. 265, 286 (1986); *Veney* v. *Wyche*, 293 F.3d 726, 730 (4th Cir. 2002); *Dry* v. *United States*, 235 F.3d 1249, 1255 (10th Cir. 2000); *Doug Grant, Inc.* v. *Greate Bay Casino Corp.*, 232 F.3d 173, 184 (3d Cir. 2000); *In re Sofamor Danek Group, Inc.*, 123 F.3d 394, 400 (6th Cir. 1997).

Policing this distinction between well-pleaded facts, on the one hand, and conclusory assertions and inferences, on the other, is necessary to ensure that a complaint "provide[s] the defendant with 'fair notice of what the plaintiff's claim is and the grounds upon which it rests.'" *Dura Pharms.*, 544 U.S. at 346 (quoting *Conley* v. *Gibson*, 355 U.S. 41, 47 (1957)). As Judge Boudin stated in *DM Research, Inc.* v. *College of American Pathologists*:

> [T]he price of entry, even to discovery, is for the plaintiff to allege a *factual* predicate concrete enough to warrant further proceedings, which may be costly and burdensome. Conclusory allegations in a complaint, if they stand alone, are a danger sign that the plaintiff is engaged in a fishing expedition.

170 F.3d 53, 55 (1st Cir. 1999).

Accordingly, "a complaint must allege, at a minimum, a sufficient factual predicate * * * to demonstrate a reasonable basis for inferring that the alleged conduct may be wrongful." Brief for the United States as Amicus Curiae Supporting Petitioners at 6, *Bell Atlantic Corp.* v. *Twombly*, No. 05-1126 (Aug. 25, 2006) ("U.S. *Twombly* Br."); see *Warth* v. *Seldin*, 422 U.S. 490, 504 (1975). Furthermore, when testing the sufficiency of a complaint, "[i]t is not * * * proper to assume that the [plaintiff] can prove facts that it has not alleged." *Associated Gen. Contractors of Cal., Inc.* v. *California State Council of Carpenters*, 459 U.S. 519, 526 (1983); see also *Wilson* v. *Schnettler*, 365 U.S. 381, 383 (1961).

As this Court has held, Rule 12 preserves courts' power "to insist upon some specificity in pleading before allowing a potentially massive factual controversy to proceed." *Associated Gen. Contractors*, 459 U.S. at 528 n.17. Using that power in sprawling securities fraud class actions is particularly appropriate for two reasons. First, because the scienter element of a securities fraud claim "critically distinguishes innocuous * * * conduct from wrongdoing, allegations concerning that element must be concrete, rather than conclu-

sory." U.S. *Twombly* Br. at 12; *cf. Hochfelder*, 425 U.S. at 198-199. Second, failing to require concrete allegations "would permit a plaintiff 'with a largely groundless claim to simply take up the time of a number of other people, with the right to do so representing an *in terrorem* increment of the settlement value, rather than a reasonably founded hope that the [discovery] process will reveal relevant evidence.'" *Dura Pharms.*, 544 U.S. at 347 (quoting *Blue Chip Stamps*, 421 U.S. at 741).[8]

2. These ordinary pleading principles apply *a fortiori* to the scienter requirement under the PSLRA because Congress has "unequivocally raise[d] the bar" for pleading that element. Pet. App. 18a. The PSLRA requires that a complaint "state *with particularity* facts giving rise to a *strong inference* that the defendant acted with the required state of mind." 15 U.S.C. § 78u-4(b)(2) (emphasis added).

Several courts of appeals have acknowledged that this heightened pleading standard "alters the normal operation of inferences under Fed. R. Civ. P. 12(b)(6)." *In re Digital Island Sec. Litig.*, 357 F.3d 322, 328 (3d Cir. 2004); see Pet. 18-19 (collecting cases). But the courts of appeals cannot agree on a uniform approach for measuring whether the facts alleged satisfy the statutory standard—especially when those facts might support inferences of both an innocent and a culpable state of mind. See Part I, *supra*.

For the reasons discussed in Part II above, Congress limited the range of permissible inferences in a securities fraud

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[8] See also *Reiter* v. *Sonotone Corp.*, 442 U.S. 330, 345 (1979) (encouraging district courts to "use the tools available" to avoid "administrative chaos, class-action harassment, or 'windfall' settlements"); *Davis* v. *Passman*, 442 U.S. 228, 237 n.15 (1979) ("It is not enough to indicate merely that the plaintiff has a grievance but sufficient detail must be given so that the defendant, and the court, can obtain a fair idea of what the plaintiff is complaining, and can see that there is some legal basis for recovery") (internal quotation marks omitted).

case by requiring the plaintiff to plead particular facts giving rise to a strong inference of scienter. Given this statutory mandate, the strength of the scienter inference must be measured in light of any competing inference of an innocent mental state that arises from the pleaded facts. Thus, a plaintiff in a case covered by the PSLRA must plead facts that strongly tend to exclude the possibility that the defendant acted with an innocent state of mind. See generally *Matsushita Elec. Indus. Co.* v. *Zenith Radio Corp.*, 475 U.S. 574, 588 (1986). The Second, Third, and Eighth Circuits have correctly adopted this approach, requiring that the facts strongly suggest knowledge of falsity. Pet. 23-25; Pet. App. 23a.[9]

3. When the Court disregards conclusory assertions and focuses on the facts actually alleged, the complaint in this case does not come close to supporting a strong inference of scienter. The Seventh Circuit analyzed four categories of allegedly false statements by Tellabs' CEO, Richard Notebaert, to determine whether the complaint adequately alleged scienter with respect to each. Pet. App. 10a, 22a. The petition thoroughly discusses each category (at 7-12, 26-28). Two examples are sufficient here to show how badly the Seventh Circuit misperceived the governing pleading standard.

First, the complaint alleges that Notebaert overstated the demand for Tellabs' TITAN 5500 product in February and March 2001. Pet. App. 12a. The complaint appears to acknowledge, however, that information about the decline emerged over several months. It does not specify when external and internal reports documenting the decline were distributed, much less when (if at all) Notebaert reviewed those reports. Pet. App. 65a. Thus, plaintiffs have alleged no facts creating a strong inference that Notebaert had knowledge contrary to his general optimistic statements, and it is not

[9] As the petition points out (at 5, 23), the Second and Third Circuits also give weight to generalized allegations of motive and opportunity. Other courts of appeals have correctly rejected that method of analysis. See Pet. 23 n.4.

proper to assume that they could prove unalleged facts at trial.

The Seventh Circuit observed that an internal report revealing the drop was written sometime in March 2001. Pet. App. 23a. But the primary statements that the Seventh Circuit identified as false were made in February and on March 8 (*id.* at 12a). The only subsequent statement it could find was a remark in April about growing demand for Tellabs' services generally. *Id.* at 23a. On April 6, Tellabs disclosed an unanticipated drop in TITAN 5500 orders during the last two weeks of March and lowered its revenue projections accordingly. Pet. 27. These alleged facts do not strongly tend to exclude the possibility that Notebaert made his positive statements about the TITAN 5500 without knowledge that demand had declined.

Second, the complaint alleges that Tellabs inflated its financial results for the fourth quarter of 2000 by engaging in "channel stuffing"—inducing purchasers to buy TITAN 5500s earlier than in the normal course. Pet. App. 13a, 55a-59a; *Greebel* v. *FTP Software, Inc.*, 194 F.3d 185, 202 (1st Cir. 1999). It alleges that Notebaert knew about the channel stuffing and worked with sales personnel to effect it. Pet. App. 25a. As the complaint defines channel stuffing, however, it is a label that applies to legitimate discounting, which is desirable and efficient conduct, as well as to illegitimate practices. Pet. 28; *Greebel*, 194 F.3d at 203 ("there may be any number of legitimate reasons for attempting to achieve sales earlier"); see also *Broudo* v. *Dura Pharms., Inc.*, 339 F.3d 933, 940 (9th Cir. 2003), *rev'd on other grounds*, 544 U.S. 336 (2005). Accordingly, as the district court held and the Eleventh Circuit recently confirmed, the general allegation that Notebaert promoted channel stuffing does not establish scienter. Pet. App. 74a; *Garfield* v. *NDC Health Corp.*, 466 F.3d 1255, 1265 (11th Cir. 2006).

Plaintiffs do allege that some of the channel stuffing consisted of illegitimate fabrication of purchase orders by

Tellabs employees, but they do not allege that Notebaert had any knowledge of such fabrication. Thus, they have not pleaded particular facts that strongly tend to exclude the possibility that Notebaert acted with an innocent state of mind. Accordingly, the district court properly dismissed plaintiffs' complaint.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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